

public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients.

In 2006, over 1,300 public companies changed their auditor and from 2002 to 2006 over 6,500 public companies changed their auditor.¹⁰⁸ Under current SEC regulations, a public company must disclose any auditor change on Form 8-K.¹⁰⁹ SEC regulations require disclosure of any disagreements on financial disclosures during the preceding two years prior to the resignation and whether some issue, such as the auditor's inability to rely on management's representations, may put into question financial disclosure reliability. SEC regulations also allow a public company to request that the auditor respond with a letter addressed to the SEC stating whether it agrees with the company's disclosure and, if it does not agree, stating why.

While the SEC does attempt to uncover through its rules whether the auditor change relates to disagreements over accounting and reporting matters, the SEC rules do not require a public company to provide a reason for the auditor's departure in the vast majority of cases. The limitations of the existing disclosure requirements have resulted in companies failing to disclose any reason for their auditor changes in approximately 70% of the more than 1,300 auditor changes occurring in 2006.¹¹⁰

The Committee considered testimony and commentary regarding the lack of clear disclosure surrounding auditor changes. Testimony and commentary viewed the lack of transparency surrounding auditor changes as detrimental to investor confidence in financial reporting.¹¹¹ Testimony and commentary suggested greater transparency regarding auditor changes would compel audit committees to more closely evaluate auditor selection decisions and lead to greater competition in the audit market.¹¹²

¹⁰⁸ See Mark Grothe and Blaine Post, *Speak No Evil*, GLASS LEWIS & CO RESEARCH 12 (May 21, 2007).

¹⁰⁹ Form 8-K, available at <http://www.sec.gov/about/forms/form8-k.pdf>.

¹¹⁰ See Mark Grothe and Blaine Post, *Speak No Evil*, GLASS LEWIS & CO RESEARCH 12 (May 21, 2007).

¹¹¹ See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy-Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 4 (Jan. 30, 2008), available at http://comments.treas.gov/_files/BAILEYCOMMENTSONTREASURYADVISORYCOMMITTEEOUTLINEFINALSUBMISSION13008.doc (recommending SEC and PCAOB disclosures of auditor changes to enhance the growth of smaller auditing firms); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 193–94), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (calling for expanded Form 8-K disclosure requirements as “in the best interest of investors”).

¹¹² See e.g., Record of Proceedings (Feb. 4, 2008) (Written Submission of Edward E. Nusbaum, Chief Executive Officer, Grant Thornton LLP, and Chairman, Grant Thornton International Board of Governors, 3), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/>

The Committee believes that explicitly stating the reason for an auditor change will assist investors in determining the quality of financial reporting and subsequent investment decisions. The Committee recommends that the SEC amend its Form 8-K disclosure on auditor changes by providing for the following mechanism: The public company would file within four days of an auditor change a Form 8-K disclosing that an auditor had resigned, was terminated, or did not seek reappointment; the company would appropriately characterize and state in all cases in plain English the reason or reasons for the change. The company would also disclose whether its audit committee agreed with the disclosure it has provided. The company would also provide the auditor with a copy of the disclosure and request a response as to the accuracy of the disclosure. The company would include any response as an exhibit to the company's Form 8-K filing, or if received following the due date for the Form 8-K, in a subsequent Form 8-K. As discussed above under current SEC regulations, the public company can request that the auditor respond to the company's statements in the Form 8-K regarding disagreements over accounting and financial matters.

In addition, the Committee recommends that auditing firms notify the PCAOB of any engagement partner changes on public company audits if made before the normal rotation period and, other than for retirement, the reasons for those changes.¹¹³

Other Issues Under Consideration

While the work of the Committee is incomplete at this point, the Committee has tentatively concluded it will not make a recommendation regarding vehicles to access outside capital. The Committee notes that some witnesses have suggested changing the capital structure of auditing firms to allow access to capital.¹¹⁴

The Committee is also considering and debating a variety of other issues. Further elaboration on these issues will be included in subsequent drafts of this Report.

02042008/Nusbaum020408.pdf (noting that the Committee should examine “[c]omprehensive disclosures about reasons for auditor switches”).

¹¹³ But cf., Record of Proceedings (Feb. 4, 2008) (Written Submission of Paul G. Haaga Jr., Vice Chairman, Capital Research and Management Company, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Haaga020408.pdf> (calling for public disclosure on audit partner changes other than for rotation requirements); Record of Proceedings (Feb. 4, 2008) (Oral Remarks of D. Paul Regan, President and Chairman, Hemming Morse Inc., 194–195 (Feb. 4, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/agendas/minutes-2-4-08.pdf> (commenting that “if an audit partner is * * * rotated [early] off of an issuer, there ought to be a disclosure, and there ought to be communication from the partner who was rotated off early as to [the reason for the early rotation] * * * because in many instances * * * there [is] controversy * * *”).

¹¹⁴ See, e.g., Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James R. Doty, Partner, Baker Botts LLP, 3 (Feb. 19, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf> (suggesting allowing auditing firms to organize as limited liability companies or corporate entities to allow for the issuance of equity or debt securities).

VII. Concentration and Competition

The Committee analyzed public company audit market concentration and competition. In its work the Committee focused on concentration and competition in the context of their impact on audit quality and effectiveness. In turn, consideration of the sustainability of the auditing profession was also subject to examination in the context of audit quality and effectiveness. The recommendations set out below reflect this focus.

During the course of its deliberations, the Committee received testimony and commentary from the Government Accountability Office (GAO), the Public Company Accounting Oversight Board (PCAOB), academics, auditing firms, investors, and others regarding audit market concentration and competition.

In January 2008, the GAO issued *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*,¹¹⁵ updating its 2003 report on audit market concentration.¹¹⁶ The GAO concluded that the four largest auditing firms continue to dominate the large public company audit market. In 2006, the four largest auditing firms audited 98% of the 1500 largest public companies with annual revenues over \$1 billion and 92% of public companies with annual revenues between \$500 million and \$1 billion. However, concentration in the small and mid-size public company audit market has eased during the past five years. The largest firms' share in auditing small public companies with annual revenues under \$100 million has declined from 44% in 2002 to 22% in 2006 and in auditing mid-size public companies with annual revenue between \$100 million and \$500 million from 90% in 2002 to 71% in 2006.¹¹⁷

The Committee considered the testimony of several witnesses regarding the reasons for the continued concentration in the large public company audit market. Auditing firms, public companies, market participants, academics, investors and others reasoned that large public companies with operations in multiple countries need auditing firms with global resources and technical and industry expertise to deal with an increasingly complex business and financial reporting environment.¹¹⁸ These needs limit

¹¹⁵ U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, GAO–08–163 (Jan. 2008) [hereinafter 2008 GAO Report].

¹¹⁶ GAO, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, GAO–03–864 (July 2003) (finding that “although audits for large public companies were highly concentrated among the largest accounting firms, the market for audit services appeared competitive according to various indicators”).

¹¹⁷ 2008 GAO Report 19. The GAO also found that the largest firms collected 94% of all audit fees paid by public companies in 2006, slightly less than the 96% they collected in 2002. 2008 GAO Report 16.

¹¹⁸ See, e.g., 2008 GAO Report 21 (surveyed companies most frequently cited size and complexity of their operations (92%), the auditor's technical capability with accounting principles and auditing standards (80%), and the need for industry